

**FINANCIAL MARKET REFORMS IN  
TURKEY BETWEEN 1980-1990**

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### Background

Successive Turkish governments pursued an inward oriented growth strategy until the end of the 1970s. However, changes in the world economic conditions after the mid-1970s and the ensuing domestic economic crisis led the authorities to review the traditional economic policies and to adopt an outward oriented growth strategy. In 1980, the government launched a structural adjustment program which was mainly based on the principles of a free market economy. During the last decade, a series of liberalization attempts and institutional arrangements were undertaken in order to implement the new economic strategy.

It was also believed that the structural adjustment policies would not be successful unless the financial markets were mature enough to meet the financing needs of an outward oriented economy. Therefore, a series of reforms were undertaken to develop the financial system in Turkey. The main idea behind the reforms was to enhance the operational and allocational efficiency of the system through liberalization and the fostering of competition. These reforms also aimed at increasing the effectiveness of monetary policy.

In order to evaluate the developments during the post-1980 period, a brief description of the conditions prevailing in the financial system before 1980 is necessary.

Turkey experienced a high degree of financial repression before 1980. The financial repression period can be characterized by negative real interest rates, credit rationing, undeveloped capital markets, excessive reliance on Central Bank resources for public sector financing requirements, severe restrictions on foreign exchange operations, and a high level of taxation on financial income and transactions. All deposit rates, and to a large extent loan rates, were determined directly by the government. These controlled interest rates were not responding to the current inflation rate. Moreover, under protectionist economic policies, some sectors had priority, and a number of complicated selective credit schemes were introduced in order to assure financial support for the import substituting sectors.

In this environment, liberalization attempts began in July 1980 with the deregulation of interest rates on loans and deposits and the introduction of certificates of deposits (CDs). This reform program was launched during a period of tight monetary policy

and other demand restrictive policies. Soon after the reform program was announced, smaller banks in particular started to compete for deposits by offering higher interest rates. However, the fiercest price competition came from unregulated brokerage houses. On the other hand, several companies found themselves in financial difficulties because of high credit interest rates and poor earnings performance due to the demand restrictive policies. All these developments brought the financial system to a crisis in 1982. Some of the smaller banks and most of the brokerage houses collapsed during the crisis. This development triggered some relaxation in monetary policy as well as changes in some regulations.

The financial crisis of 1982 had several far-reaching affects on the markets. The magnitude of non-performing loans became a major problem. In reaction to the financial crisis, the regulations and reforms which were instituted after that event reflected an extra dose of caution on the side of the regulators. It was clearly observed that reforms often produce undesired results when implemented without an adequate regulatory and supervisory framework. Finally, the importance of the timing and speed of the reforms was understood. However, the financial market reforms continued throughout the decade taking into consideration the lessons derived from the early attempts.

#### **Money and credit markets**

A free interest rate policy was a major step towards the liberalization of the financial system. Interest rates on bank loans and deposits were freed in 1980. However, after the financial crisis, the Central Bank started to reregulate interest rates on deposits in 1983. Although the Central Bank tried to maintain positive real interest rates on savings deposits in order to promote financial savings, it proved difficult to maintain positive real interest rates in an environment with a high and volatile inflation rate since the ceilings on deposit rates were adjusted infrequently. As a result, in July 1987, the interest rates on deposits with one year maturity and on CDs with denominations over 10 million Turkish Liras were deregulated with the hope of attracting financial savings to longer maturities. Following this change, banks increased the interest rates on one year deposits, and there was a shift in the maturity composition in favor of one year deposits. Meanwhile, inflation was increasing rapidly, and the oligopolistic structure of the deposit market facilitated collusion among banks in avoiding further deposit rate increases. By the end of 1987, interest rates on time deposits turned unacceptably negative again, and this led to a shift in favor of deposits with short maturities. Moreover, foreign currency became an attractive instrument for portfolio holders. These developments had destabilizing effects on the financial markets.

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In February 1988, the government announced a comprehensive package of measures to mop up the excess liquidity and to reestablish stability in the financial markets. This package, which included higher interest rates on all deposits, was successful in stabilizing the financial markets. However, they also increased the banks' costs of funds. This increase in costs put the banks into a difficult situation in placing these funds. As a result, the level of interest rates had to be reconsidered again, this time in a downward direction to ease the difficulties the banking sector was facing. However, the continuing rise in inflation rate did not produce the expected results, and the disequilibrium in the financial markets continued. The most obvious indicator of that disequilibrium was the heavy speculation by banks in foreign exchange. The instability was finally put to an end by freeing the interest rates on all types of deposits in October 1988. This action led to a bullheaded price competition in the deposit market, causing the annual rate to jump from a 65 percent level to an 85 percent level in just a few days. In the following months, the banking sector faced a massive inflow of deposits while the market for bank loans became increasingly risky due to excessively high lending rates. Although deposit interest rates came down gradually in 1989 and in the first half of 1990, the banking sector, large deposit banks in particular, had a difficult time in profitably placing funds with corporate clients until several months later when the effect of the early inflow of high cost deposits faded away.

While these policy shifts between regulated and liberalized interest rates continued during the decade, some very important institutional developments also took place. The most important institutional change that affected the working of the banking system was the establishment of an interbank money market in 1986. The purpose was to satisfy the short term liquidity requirements of the banks by mobilizing the excess liquidity available elsewhere within the banking system. The market works under the auspices of the Central Bank.

The high cost of financial intermediation is one of the major deficiencies of the Turkish financial markets. In order to reduce the cost of financial intermediation, the tax rates imposed on various instruments were lowered. In 1983, the withholding tax on interest income from bank deposits was reduced from 25 percent to 20 percent. However, at the same time, considering the malpractice of CDs during the crises of 1982, the withholding tax on CDs was increased from 25 percent to 30 percent. In 1984, the withholding tax on interest income on all bank deposits (including CDs) was reduced to a unified 10 percent. In 1981, the banking and insurance transaction tax rate was cut from 25 percent to 15 percent. In 1984, this tax rate was further reduced to 3 percent but was readjusted to 5 percent in 1989.

## Securities markets

During the 1980s, some legal and institutional arrangements were introduced in order to foster the development of the securities markets. The reform process began in 1981 with the enactment of the Capital Market Law. Following the enactment of the Law, the Capital Market Board was established in 1982 to regulate, develop and supervise the capital markets.

In the period between 1982 and 1986, the legal and institutional framework of the securities markets was formed. The Capital Market Law gave the Capital Market Board the authority to regulate the primary markets. The Board issued communiques defining the disclosure standards in the new issues markets for various new instruments. In order to provide protection to investors, there were also some other legal arrangements related to the intermediaries in the securities markets setting the operational standards. Additionally, the Capital Market Board also established some principles regarding the financial reporting system. An optional general accounting plan was prepared for corporations. In 1983, a new legal arrangement was enacted for the regulation of the secondary markets. This new arrangement empowered the Capital Market Board to initiate the establishment of stock exchanges and to regulate all operations in these markets. The Istanbul Stock Exchange was reopened in 1985 and became operational in 1986.

Following the formation of the legal framework in the first half of the 1980s, several mechanisms, including tax incentive measures, were devised to promote the deepening of the securities markets. With these arrangements:

a) The double taxation of dividends was prevented. In 1985 the corporate income tax rate was raised to 46 percent from 40 percent, becoming the only tax on dividend income. The government was given the authority to lower this rate to 40 percent as an incentive for public corporations. Additional incentives were given to public corporations by amending the tax laws in 1987. Most notably, the government was given the authority to lower the income tax rate to 35 percent or even to 30 percent for public corporations depending on the percentage of shares held by small shareholders.

b) Capital gains became tax free in 1985. This was granted upon the condition that the security was listed on an exchange and held for at least one year. In 1987, with an amendment of this provision, capital gains from the sales of securities sold through licensed intermediary agencies were also made tax free. Premiums emanating from stock issuing also became tax free for any stock, listed on an exchange, that does not distribute the premium to shareholders.



c) Interest income on government securities was made tax free for individuals. However, they are subject to a 10 percent withholding tax if held by corporations. Interest income on corporate bonds are subject to a 10 percent withholding tax if held by individuals.

In order to promote the demand for securities, the Capital Market Law set provisions regarding the establishment and operations of mutual funds. So far only banks are allowed to establish and manage mutual funds. The revenues of the mutual funds from their portfolio management operations are free of corporate income taxes. The number of mutual funds reached 71 by the end of 1990, and their total market value was about TL 1500 billion (approximately US \$500 million).

The privatization of the State Economic Enterprises, which started in 1988, contributed to the deepening of the capital markets by increasing the volume of new issues. Under the privatization scheme, certain percentages of the stocks of selected enterprises are being sold to the public. By the end of 1990, the market value of the stocks sold was about US \$800 million.

Along with the development of the securities markets, a number of new instruments have been introduced. Finance bills, participation certificates of mutual funds, bank bills, bank guaranteed bills, and certificates of revenue partnership are among these newly introduced instruments. Several large industrial corporations have started to recourse to the securities markets in order to meet their financing needs. Moreover, some of these corporations have also started to rely on equity financing and to open up their companies to the public. The liberalization of capital movements in August 1989 has also contributed to the growth of the securities markets by allowing non-residents to invest in domestic securities quoted on the capital market.

As a result of the rapid growth in the securities markets, a need for improving the existing legal framework has arisen. Some amendments are being made in the existing Capital Market Law, and they are expected to be approved by the Parliament soon. With these amendments, the duties and authorities of the Capital market Board will be extended. Furthermore, in compliance with generally accepted principles throughout the world, insider trading is explicitly defined as an illegal activity with penalty clauses included for people involved in such deals.

#### **Foreign exchange**

The integration of the Turkish financial system with the international markets has been one of the major objectives of the financial market reforms. Over the past ten years,

the regulations have changed substantially in order to liberalize foreign exchange transactions.

The Turkish Lira was often kept overvalued and devalued irregularly until 1980. From the beginning of the reform attempts, the government decided that the exchange rate should reflect the real value of the domestic currency. As a first step, the Turkish Lira was devalued substantially in January 1980. In May 1981, the Central Bank took a step in the direction of liberalization by adopting the crawling peg regime in which exchange rates are adjusted daily.

During the period between 1980 and 1983, the multiple exchange rate practices introduced during the previous decade were eliminated; commercial banks were given more authority in aligning their foreign exchange positions; and exporters were permitted to hold a portion of their earnings as foreign exchange sight deposits with commercial banks.

In 1984, banks were allowed to engage in foreign exchange operations within certain limits in proportion to their foreign exchange liabilities; the surrender requirement, the proportion of foreign exchange acquisitions that banks are obliged to sell to the Central Bank, was reduced in the case of export earnings and was eliminated for invisibles; banks were allowed to accept foreign exchange deposits including those of resident Turkish citizens; and restrictions on foreign travel and investment from abroad were eased and simplified.

The exchange rate determination process was further liberalized by permitting banks to set their own rates within a specified band around the Central Bank rate. An important development in the context of liberalization was the opening of an official foreign exchange market under the auspices of the Central Bank in September 1988. The participants of this market are banks and the authorized foreign exchange bureaus. The opening of this market was important in at least two respects: First, the exchange rate for the Turkish Lira would be determined according to demand and supply conditions; second, it provided a tool for the more efficient management of foreign exchange and the currency reserves of the banking sector.

Following these major steps, banks' operations in foreign currency have grown substantially, and foreign exchange deposits have become a major component of the broader definitions of the money supply.

In 1986, in order to prevent the banks from taking excessive risks and to ensure a regular inflow of foreign exchange to the Central Bank, some new measures were taken to regulate the foreign exchange positions of the banks. With these measures:

a) All kinds of foreign exchange earnings of the banks, including earnings from exports and invisibles, became subject to the surrender requirement.

b) The liquidity requirement, which obliged banks to hold a specified portion of their short-term foreign liabilities in the form of liquid foreign assets, continued.

c) An exchange rate risk ratio, aiming to bring the foreign exchange assets and liabilities of the banks into balance, was introduced.

d) Banks were required to extend at least 50 percent of their foreign exchange deposits as foreign currency credits to residents in order to promote foreign exchange generating activities. However, this rule was abolished in 1990.

On the other hand, the rapid growth of foreign exchange deposits made the implementation of monetary policy more difficult. Subsequently, these deposits became subjected to legal reserve requirements in 1986. Initially, interest earnings from foreign exchange deposits were not subject to taxation. To halt currency substitution, a 5 percent withholding tax was introduced on these earnings as part of the February 1988 policy measures. The withholding tax rate was increased to 10 percent in 1989.

The Turkish foreign exchange regime was further liberalized in 1989 and 1990. Decree No.32, regarding the protection of the value of the Turkish currency, was issued in August 1989. The decree constituted a very important step towards the liberalization of the exchange regime. This was followed, in February 1990, by an application to the International Monetary Fund for full convertibility of the Turkish currency (within the framework of Article 8). With these changes:

a) Residents were permitted to buy foreign exchange from banks and other eligible financial institutions. They were also allowed to freely use their foreign exchange accounts.

b) Non-residents were allowed to buy and sell Turkish securities quoted on the domestic stock exchange or government securities through intermediary institutions operating in Turkey. They were also allowed to transfer income and the sales proceeds of these securities abroad through banks and other eligible financial institutions.

c) Residents were permitted to purchase securities quoted on foreign stock exchanges or government securities issued by foreign countries through eligible financial institutions. They were also allowed to transfer the foreign exchange required to purchase such securities abroad.



d) Controls on capital movements (rules governing credit inflows to and outflows from Turkey) were eased substantially.

e) Banks were allowed to freely determine the foreign exchange rates that they use in their operations.

It can be said that the recent revisions in the foreign exchange regulations have brought the Turkish Lira much closer to both current and capital account convertibility.

### Monetary policy

Before the commencement of the auctioning of government securities in 1985, the public sector borrowing requirement was met either by on tap issues of such securities or through Central Bank financing. Because of the latter, monetary policy was subordinate to fiscal policy. With the auctioning of government securities, the Treasury became able to raise an increasing portion of its financing needs from the market. This way of financing of the public sector deficit has reduced the burden on the Central Bank. Moreover, the cost of borrowing is determined under market conditions. Thus, any easing or tightening of the money market is passed on to the Treasury, and the size of the public sector borrowing requirement has a very significant influence on market interest rates. Consequently, the outcome of each auction gives a signal to the market regarding interest rates.

As it was stated earlier, some important revisions were made in the interest rate policies during the 1980s in order to promote domestic financial savings. However, with the Central Bank obliged to finance the public sector deficits and support selective credit schemes, monetary policy still lacked adequate instruments for effective control of the liquidity in the system. Therefore, the need for a change in the implementation of monetary policy, by shifting the emphasis from direct interference in public and private sector portfolios to the control of monetary expansion through control of the reserves of the banking sector, was obvious.

Various new institutional arrangements were necessary for the implementation of the new monetary policy. First of all, the Central Bank simplified the liquidity and reserve requirement systems and shortened the compliance lag for these requirements to establish a stable relation between the reserves of the banks and the money supply.

Under the reserve requirement system, banks are obliged to deposit a certain percentage of their deposits with the Central Bank. Previously, reserve ratios were differentiated for sight and time deposits. The reserve requirement system was also

used as an instrument of selective credit policy by setting preferential ratios on deposits earmarked for special purpose credits. The required reserve ratio for all deposits was unified in 1985. In addition, the monthly reporting frequency was shortened to a weekly one, and the lag in fulfilling the reserve requirement was reduced from six to two weeks. In 1986, legal requirements were extended to foreign exchange deposits. However, in order to channel savings to time deposits with longer maturities, the implementation of differentiated reserve requirement ratios, depending on the maturity of deposits, was started again in 1988.

Under the liquidity requirement system, banks are obliged to hold a certain percentage of their deposits in the form of vault cash, free reserves at the Central Bank, and government securities. As in the case of the reserve requirement, the compliance lag for the liquidity requirement was reduced to two weeks.

Both the liquidity and the reserve requirement ratios have been used to control the liquidity of the economy. In order to facilitate the sales of government securities, the interest earning portion of the liquidity requirement was augmented in recent years. Increases in the interest earning portion help to minimize the burden of the liquidity requirement on banks. On the other hand, there have been reductions in the required reserve ratios recently, and further cuts are anticipated in the medium term.

The rediscount facilities of the Central Bank were traditionally used in financing the preferential sectors of the economy. Beginning in 1984, the scope of the rediscount facilities has been gradually reduced, and they were mainly limited to medium-term credits. With a decision made in October 1989, the Central Bank's practice of extending medium or long term credits in the form of advances against bonds was terminated. It was decided that the rediscount credits would only be extended against short term company paper. Thus, the practice of using rediscount as a selective credit policy tool came to an end, and the rediscount window, by enabling the Central Bank to match the maturity structure of its assets with those of its liabilities, became an effective instrument of monetary control.

These new institutional arrangements, coupled with the establishment of the interbank money market, made the commencement of open market operations feasible in 1987. The start of open market operations marked a significant change in the management of monetary policy, with a transition to a market oriented monetary policy based on controlling the total reserves of the banking system. Through the outright purchases and sales of government securities and repurchase agreements, the Central Bank can regulate the reserve position of banks. Besides its actions in the government securities

market, the Central Bank conducts open market operations in the interbank money market as well.

Following these structural changes, the management of monetary policy became more complex due to the inter-relations among various markets and the increase in capital movements resulting from the liberalization of foreign exchange regulations. Some further institutional arrangements were launched in 1989 facilitate the implementation of a new approach in monetary policy.

The most important institutional arrangement in 1989 was an accord signed in March between the Treasury and the Central Bank. The accord imposed a ceiling on the short term advances to the Treasury which are given at a much lower interest rate (4 percent) than the market rate. When the short term advances to the Treasury exceed this amount, the Treasury is charged the going market rate. Furthermore, the Treasury accepted a second ceiling, which is much lower than the legal limit, for the automatic realization of its demands to use advances from the Central Bank. This was an important step in limiting the credits given to the public sector.

All these changes paved the way for the successful launching of the monetary program in January 1990. The Central Bank announced its monetary program for 1990 as an integral part of a medium term scenario. The monetary program, unlike classical monetary targeting exercises, refrains from targeting any monetary aggregate; instead, it focuses on reshaping the structure of the Central Bank's balance sheet. By doing this, the Central Bank aims at reducing the rigidities in its balance sheet that inhibit the enhancement of the efficiency of the monetary policy. On the other hand, it is extremely difficult, if not impossible, to target monetary aggregates under high inflation and rapid structural change and, at the same time, preserve the credibility of such a program. In other words, the Central Bank's monetary program should be considered as a part of the structural reforms in the financial system.

The monetary program has four quantitative targets chosen from the balance sheet of the Central Bank. These targets are the total size of the balance sheet, the total domestic liabilities of the Central Bank, the total domestic assets of the Central Bank, and the Central Bank money (defined as the total TL liabilities of the Central Bank). Once these items are specified, some other targets can also be mathematically derived. The numerical targets were given in the form of upper and lower limits for each variable. Among the four basic targets, the Central Bank money was given the highest priority. By the end of 1990, this variable was below the lower limit, while the balance sheet total was slightly above the upper limit. The other two variables, the total

domestic liabilities and the total domestic assets of the Central Bank, were between the specified limits. (The targets and the realizations of the 1990 monetary program are given in the second annex.)

### The banking system

The Turkish financial system is mainly dominated by the banking system, and the financial market reforms have further strengthened the privileged position of the commercial banks. Particularly, the Capital Market Law has taken the dominance of banks in the financial system as a given, and has allowed banks to engage in all types of capital market activities. Consequently, the development of the capital markets has broadened the spectrum of the banks' activities. The result is a universal banking system where banks are allowed to engage in all financial activities with the exception of the leasing and the insurance businesses. However, banks own most of the leasing and insurance companies. Moreover, they have been empowered with monopoly rights in some of the the financial activities, such as establishing and managing mutual funds.

The ratio of the total assets of banks to the GNP reached 56.6 percent in 1989. The ratio of funds transferred through the banking system to the total transfers of funds was almost 80 percent during the 1982-1987 period.

A rapid increase in the number of banks has been observed over the past few years. By the end of 1990, the Turkish banking system was composed of 66 banks plus the Central Bank. Five of these banks are development banks and five are investment banks, and the rest are all-purpose deposit money banks. The new banks that entered the banking system during the 1980s are small institutions, most of which operate with only one or two branches. The development banks grant medium and long term investment credits mostly to industry. They also provide working capital, render project services, and are involved in the securities business. These banks and the investment banks are not allowed to accept deposits. They borrow from international organizations and raise funds in both domestic and international capital markets.

Eight banks out of 56 deposit money banks are state owned. Most of the state owned banks were established for special purposes. Among the privately owned 48 deposit money banks, 23 are foreign. These banks, with the exception of the Ottoman Bank (which was established in 1863 and served as a central bank until the 1920s) are small institutions. Their market share is not significant. At the end of 1985, the shares of foreign banks were 1.8 percent and 3.2 percent in total deposits and commercial bank credits, respectively. These ratios increased to 2.4 percent and 3.7 percent at the end of 1990. However, it can be argued that despite their insignificant market share, foreign

banks have an important place in the Turkish banking system because of the new concepts and practices that they have introduced. Most of the foreign banks specialize in corporate banking. Their customers are multinational corporations and high-ranking Turkish companies. They are mainly involved in foreign exchange operations and trade financing. Some of these banks also engage in investment banking activities and take part in the privatization attempts which have started in recent years.

The total assets of the five largest banks amount to more than half of the total assets of the banking system. Due to the high capital requirements and the increased cost of operating nationwide branch networks, the new entrants and the existing small banks do not tend to compete for deposit money banking activities with the well-established and large banks. However, the diversification of banking activities has created an environment where new entrants and other small banks can effectively operate in various areas. The wholesale end of the market is especially competitive. On the other hand, banks do not face any effective competition from other financial institutions in Turkey.

The implementation of the new monetary policy, the establishment of foreign exchange and interbank money markets, and the liberalization of the foreign exchange regulations have encouraged banks to improve their asset and liability management policies by introducing additional funding sources and new areas of use. Moreover, increased competition has also encouraged banks to diversify and to develop the quality of services that they offer to their customers. Thus, they have been adopting advanced technology in their operations at an increasing rate. The outcome has been encouraging so far. The banks have been successful in adjusting to new circumstances and in performing modern banking practices.

Banking activities are regulated by the Banking Act of 1985. The Banking Act contains provisions regarding the establishment and capital structure of banks, branch banking, foreign banking, deposits, credits and other investments, deposit insurance, and the transfer, merger and liquidation of banks. In line with the Banking Act, the accounting and reporting standards and the principles of auditing and supervision were also established.

The establishment of a domestic bank requires authorization from the Council of Ministers. It must be founded in the form of a joint stock company, and the number of shareholders shall not be less than 100. The opening of new branches requires prior authorization by the Ministry to which the Treasury is attached.



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The Banking Act requires a minimum amount of net worth (capital and reserves) for the establishment of a bank. In addition, certain amounts of capital shall be provided for each branch, depending on the population of cities where these branches are to operate. These minimum amounts are subject to periodical adjustments.

The same rules apply to foreign capital in the case of establishing a bank in Turkey. Foreign banks are also allowed to enter the market through opening branches in Turkey, and again, the permission of the Council of Ministers is required. Their capital shall not be less than US \$10 million for the first branch office and US \$5 million for each additional branch office. The total number of branch offices they can open is limited to 5. The establishment of representative offices by foreign banks is subject to the permission of the Ministry to which the Treasury is attached. The representative offices are not allowed to accept deposits or to engage in banking activities.

According to the Banking Act, banks are subject to lending limits to avoid excessive risk concentration. The total cash and non-cash credits and other investments of a bank can not exceed 20 times the net worth of that bank. There are also limits on the credits extended to individual customers and banks' own equity participations, and on the magnitude of large loans.

Banks are required to maintain their accounts and prepare their financial statements in accordance with the unified accounting and reporting methods introduced in 1986. They are obliged to forward these statements to the Central Bank and the Treasury on a regular basis. Furthermore, banks are also required to be audited by independent auditing institutions. Reports prepared by these institutions are submitted to the Central Bank and the Treasury.

The policy changes which were summarized in the previous paragraphs caused major structural changes in the banking system. One major objective of these reforms was to increase the efficiency of the system through the fostering of competition among banks. However, there has been a rise in the risks faced by banks. Therefore, new legal arrangements were introduced to ensure the stability and the soundness of the banking system. In order to strengthen the financial structure of the banks, a new legal arrangement regarding the "Capital Adequacy Ratio" was introduced in October 1989. According to the new arrangement, prepared in accordance with the guidelines proposed by the Cooke Committee, all banks were required to maintain a 5 percent capital adequacy ratio in 1989 and must reach 8 percent by 1992. Moreover, international standards were introduced in 1988 for classification of loans and for the provisions for non-performing loans.

On-site banking supervision is carried out by the Sworn Bank Auditors who are associated with the Treasury. The Sworn Bank Auditors check the application of the Banking Act and other relevant laws by the banks, the conduct of all types of banking operations, the identification and analysis of relations between bank assets, claims, net worth, liabilities, profit and loss accounts, and of other factors affecting the financial structure of banks. The Central Bank, which conducts off-site supervision, gathers the financial data required for supervision and examines the financial standings of banks, and submits its views to the Prime Ministry together with its suggestions when necessary.

If, as a result of the audits, it is ascertained that the financial structure of a bank is eroding seriously, the Ministry to which the Treasury is attached may ask the board of directors of that bank to introduce certain measures which are stated in the Banking Act in order to improve the financial structure of the bank. If the financial structure of the bank continues to deteriorate despite the introduction of these measures, the Council of Ministers may decide that the bank be transferred to or merged with another bank.

The protection of depositors is provided through the Savings Deposits Insurance Fund. In this system of deposit insurance, deposits up to 6 million Turkish Liras are insured (100 percent for the first 3 million and 60 percent of the second 3 million). The Fund is managed by the Central Bank.

#### **Annex 1: A summary of general trends in the financial system**

The behavior of the monetary aggregates and the growth of various financial assets give some indication of the development pattern of the Turkish financial system in recent years. Since these are high inflation years, absolute figures do not show anything more than ever-increasing trends over the years. Therefore, the figures regarding the monetary aggregates and financial assets are given as percentages of GNP in the following two tables.

The first table provides the three most widely used monetary aggregates as a percentage of GNP. The reason for the inclusion of M2X (M2 plus foreign exchange deposits) is the increasing importance of foreign exchange denominated deposits after 1984.

The second table shows the extent of the change in the financial asset composition of the Turkish economy, measured as a percentage of GNP. First, there is a decline in the share of the currency in circulation and the Lira denominated bank deposits, especially in 1988 and 1989. Second, the growth of the foreign exchange denominated deposits

from zero to about five percent of GNP in the second half of the 1980s is quite sensational. The provision of foreign exchange deposit services by banks facilitated the flow of foreign currency holdings into the banking system after 1984. Thus, the already existing process of currency substitution was institutionalized in the form of foreign exchange deposits. Third, the growth of private securities does not exhibit a strong trend. However, 1988 and 1989 seem to be particularly good years in terms of the development of the private sector stock market. Fourth, the most spectacular growth rate is observed in the case of total public securities. The increase from 3.86 percent of GNP to 9.02 percent is a clear indication of heavy public sector borrowing from the financial markets.

From the previous discussion, the growth of foreign exchange denominated financial assets and the change in the financing patterns of the public deficits can be underlined as the most important factors affecting the financial asset composition of the economy during the period under investigation.

Monetary aggregates as a percentage GNP

	M1	M2	M2X
1982	11.64	22.79	-
1983	12.57	23.90	-
1984	9.55	22.43	23.11
1985	8.87	24.06	25.79
1986	8.97	24.46	27.54
1987	9.61	22.98	27.38
1988	8.21	19.74	25.11
1989	7.78	20.29	25.25

Financial assets as a percentage of GNP

	1982	1983	1984	1985	1986	1987	1988	1989
<u>Currency in Circulation</u>	4.22	3.87	3.60	3.38	3.41	3.57	3.14	3.19
<u>Sight Deposits</u>	7.42	8.70	5.95	5.49	5.56	6.04	5.07	4.59
<u>Time Deposits</u>	11.15	11.33	12.88	15.19	15.49	13.37	11.53	12.51
<u>Foreign Exchange Deposits</u>	-	-	0.68	1.73	3.08	4.40	5.37	4.96
<u>TOTAL DEPOSITS</u>	18.57	20.03	19.51	22.41	24.13	23.81	21.97	22.06
<u>Private Debt Instruments</u>	0.57	0.51	0.36	0.35	0.45	0.87	0.85	0.70
<u>Shares</u>	2.04	2.02	1.84	1.77	2.02	2.76	3.13	3.89
<u>Mutual Fund Certificates</u>	-	-	-	-	-	0.08	0.09	0.15
<u>TOTAL PRIVATE SECURITIES</u>	2.61	2.53	2.19	2.12	2.48	3.71	4.08	4.75
<u>Government Bonds</u>	2.12	3.05	2.89	3.71	3.84	4.12	4.88	6.34
<u>Treasury Bills</u>	1.74	0.48	1.85	1.76	2.09	3.29	2.54	2.05
<u>Income Sharing Certificates</u>	-	-	0.05	0.54	0.94	1.76	0.98	0.63
<u>TOTAL PUBLIC SECURITIES</u>	3.86	3.53	4.79	6.02	6.88	9.18	8.41	9.02
<u>TOTAL SECURITIES</u>	6.47	6.06	6.99	8.13	9.36	12.89	12.49	13.77

NOTES

1) Private Debt Instruments consist of corporate bonds, commercial paper and banks bills.

2) Currency in Circulation, Sight, Time and Foreign Exchange Deposits are the averages of monthly figures. Securities are calculated as the average of year-end figures.

SOURCES: Money and deposit figures are obtained from the Quarterly Bulletin of the Central Bank. Series for public sector securities are obtained from the Treasury Bulletins. There are no official series for the private sector securities stock in Turkey. The figures reported here are from an unpublished study by the Research Department of the Capital Market Board.

**Annex 2: The monetary program of 1990: targets and realizations**

	12/1989	1990(Program)	12/1990
The Balance Sheet Total			
(TL trillion)	49	55-60	60.8
(% annual change.)	30	12-22	24.1
Total Domestic Liabilities			
(TL trillion)	28.3	32.5-35.5	34.4
(% annual change)	41.6	15-25	21.6
Total Domestic Assets			
(TL trillion)	31	33-36	34.7
(% annual change)	16	6-16	11.9
Central Bank Money			
(TL trillion)	18.5	25-27.5	23.5
(% annual change)	59	35-48	26.6

Source : The Central Bank of Turkey, 1990 Annual Report

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